International Journal of Financial Management (IJFM)
ISSN(P): 2319-491X; ISSN(E): 2319-4928
Vol. 7, Issue 4, Jun-Jul 2018, 27-36

International Academy of Science, Engineering and Technology
Connecting Researchers; Nurturing Innovations

STRATEGIC INSURGENCE OF FIIs IN INDIAN STOCK MARKET

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ABSTRACT

The Foreign Institutional Investors (FIIs) have emerged as important players in the Indian Stock Market in the recent past. It's a general belief that Foreign Institutional Investments (FII's) has widespread effect on Indian Stock Market. This study makes an attempt to develop an understanding of the factors influencing FIIs while making investment in Indian stock market along with the relationship between FII investments and stock market. We found that there is positive association between FII investments and BSE sensex and showing direct relationship between each other. FIIs have tremendous power to determine & decide the direction of Indian stock market. Regulation and Trading Efficiencies, New Issuance Attractive Markets, Infrastructure, Outsourcing, Capital expenditure Cycle, Dollar Weakness, Rising Commodity Prices and Consolidation are some factors which are significantly contributed to causes of FII investments in India.

KEYWORDS: *Foreign Institutional Investors (FIIS), Indian Stock Market, Determinants of FII Flows*

Article History

Received: 24 Jun 2018 | Revised: 05 Jul 2018 | Accepted: 12 Jul 2018

INTRODUCTION

Since 1990-91, the Government of India embarked on liberalization and economic reforms with a view of bringing about rapid and substantial economic growth and move towards globalization of the economy. As a part of the reforms process, the Government under its New Industrial Policy renovates its foreign investment policy recognizing the growing importance of foreign direct investment as an instrument of technology transfer, augmentation of foreign exchange reserves and globalization of the Indian economy. Simultaneously, for the first time, the Government has been permitted portfolio investments from abroad by foreign institutional investors in the Indian capital market. The entry of FIIs seems to be a follow up of the recommendation of the Narsimhan Committee Report on Financial System. While recommending their entry, the Committee, however did not elaborate on the objectives of the suggested policy. The committee only suggested that the capital market should be gradually opened up to foreign portfolio investments. From September 14, 1992 with suitable restrictions, FIIs were permitted to invest in all the securities traded on the primary and secondary markets, including shares, debentures and warrants issued by companies which were listed or were to be listed on the Stock Exchanges in India. While presenting the Budget for 1992-93, the then Finance Minister Dr. Manmohan Singh had announced a proposal to allow reputed foreign investors, such as Pension Funds etc., to invest in Indian capital market.

Foreign Institutional investors (FIIs) are entities established or incorporated outside India and make proposals for investments in India. These investment proposals by the FIIs are made on behalf of sub accounts, which may include foreign corporate, individuals, funds etc. In order to act as a banker to the FIIs, the RBI has designated banks that are authorized to deal with them. The biggest source through which FIIs invest is the issuance of Participatory Notes (P-Notes), which are also known as Offshore Derivatives. SEBI defines foreign institutional investor (FII) is as an institution established or incorporated outside India which proposes to make investment in India in securities of companies incorporated in India.

It is used most commonly in India to refer to outside companies investing in the financial markets of India. In order to trade in Indian equity market foreign corporations need to register with SEBI as Foreign Institutional Investor (FII).

The Indian Government keep making efforts to woo international investors. Market regulator Securities and Exchange Board of India (SEBI) has recently approved of the recommendations of the Chandrasekhar committee report which makes FIIs' entry into Indian markets easier and faster. The new norms have lessened the time required for registration and documentation. The suggestions of the committee have also lowered Know Your Client (KYC) requirements for Government-supported entities and they also do not require going through registration process with the regulator.

Moreover, SEBI has merged FIIs sub-accounts and qualified foreign investors (QFIs) into a new investor class to be termed as 'foreign portfolio investors' (FPIs). Neither FIIs nor their sub-accounts will require prior registration with the regulator. Instead, they would register themselves directly with designated depository participants (DDPs).

Presently, foreign investors require permits from the regulator in monthly auctions for any investment in government bonds. The Finance Ministry has indicated that foreign portfolio investors (FPIs) will get all the tax benefits available to foreign institutional investors (FIIs). They also will not have to fulfill the Know Your Customer (KYC) norms separately for opening bank accounts. This initiative has definitely encouraged foreign investment in the Indian capital market. However, global liquidity factors and investment scenario in other emerging economies would be a real challenge for attractive foreign investments into India.

Monitoring Foreign Investments

The Reserve Bank of India monitors the ceilings on FII/NRI/PIO investments in Indian companies on a daily basis. For effective monitoring of foreign investment ceiling limits, the Reserve Bank has fixed cut-off points that are two percentage points lower than the actual ceilings. The cut-off point, for instance, is fixed at 8 per cent for companies in which NRIs/ PIOs can invest up to 10 per cent of the company's paid up capital. The cut-off limit for companies with 24 per cent ceiling is 22 per cent and for companies with 30 per cent ceiling, is 28 per cent and so on. Similarly, the cut-off limit for public sector banks (including State Bank of India) is 18 per cent.

Once the aggregate net purchases of equity shares of the company by FIIs/NRIs/PIOs reach the cut-off point, which is 2% below the overall limit, the Reserve Bank cautions all designated bank branches so as not to purchase any more equity shares of the respective company on behalf of FIIs/NRIs/PIOs without prior approval of the Reserve Bank. The link offices are then required to intimate the Reserve Bank about the total number and value of equity shares/convertible debentures of the company they propose to buy on behalf of FIIs/NRIs/PIOs. On receipt of such

proposals, the Reserve Bank gives clearances on a first-come-first served basis till such investments in companies reach 10 / 24 / 30 / 40/ 49 per cent limit or the sectoral caps/statutory ceilings as applicable. On reaching the aggregate ceiling limit, the Reserve Bank advises all designated bank branches to stop purchases on behalf of their FIIs/NRIs/PIOs clients. The Reserve Bank also informs the general public about the `caution' and the `stop purchase' in these companies through a press release.

OBJECTIVE OF THE STUDY

The main objectives of the study are as following:

- To study the trends and pattern of FII investments in the Indian stock market.
- To study the factors that affects the FII investments in India.

DATA AND METHODOLOGY

This study is based on secondary data. BSE Sensex as most popular Indian stock market indices were considered as the representative of stock market. The required data related FII has been collected from annual reports of Securities Board Exchange of India and BSE Sensex data has down loaded from the websites of Bombay stock exchange India. Monthly closing figure of the index are taken for the study. Karl's Pearson coefficient of correlation was used for data analysis which is a statistical measure that determines the degree to which two variable's movements are associated.

FOREIGN INSTITUTIONAL INVESTORS IN INDIA

FIIs are among the major sources of liquidity for the Indian markets. India opened its stock market to foreign investors in September 1992, and in 1993, received portfolio investment from foreigners in the form of foreign institutional investment in equities. This has become one of the main channels of FII in India for foreigners. Initially, there were many terms and conditions which restricted many FIIs to invest in India. But in the course of time, in order to attract more investors, the major source (almost 50%) of money the FIIs invest is from the issue of Participatory Notes (P-Notes) or what are sometimes called Offshore Derivatives. They are instruments used by foreign investors that are not registered with the SEBI (Securities & Exchange Board of India) to invest in Indian stock markets. For example, Indian-based brokerages buy India-based securities and then issue Participatory Notes to foreign investors. Any dividends or capital gains collected from the underlying securities go back to the investors. That is why they are also called Offshore Derivative Instruments. Foreign Institutional Investors (FII) include the various foreign based categories such as Pension Funds, Mutual Funds, Investment Trust, Insurance or reinsurance companies, Investment Trusts, Banks, Endowments, University Funds, Foundations, Charitable Trusts or Charitable Societies.

If FIIs are investing huge amounts in the Indian stock exchanges then it reflects their high confidence and a healthy investor sentiment for our markets. But with the current global financial turmoil and a liquidity and credit freeze in the international markets, FIIs have become net sellers (on a day to day basis). The entry of FIIs in India has brought mixed consequences for our markets, on one hand they have improved the breadth and depth of Indian markets and on the other hand they have also become the major sources of speculation in testing times like these.

FIIS AND INDIAN STOCK MARKET

Indian stock market has experienced a steady growth in terms of registered FIIs In 2006, there were 932 FIIs

registered with SEBI, of which 115 were registered in the first half of 2006 itself and 1110 FIIs were registered with SEBI as on October 5, 2007.During 2012-13, there was a decrease in the number of Foreign Institutional Investors (FIIs) registered with SEBI. As on March 31, 2013, there were 1,757 FIIs registered with SEBI as compared to 1,765 a year ago, showing a decrease of eight (in number) during the year. However, the number of registered sub-accounts has increased marginally to 6,335 as on March 31, 2013 compared to 6,322 as on March 31, 2012. Fresh FIIs were registered. Further, 581 fresh sub-account were registered with SEBI during have been registered by SEBI out of which USA has the maximum number of 578, followed by UK (207), Luxembourg (125), Mauritius (101), Canada (79) and Singapore (75) respectively. Status of registration of FIIs, sub-accounts and custodians during 2012-13 is provided in the following table:

Table 1: Number of Registered FIIs, Sub-Accounts and Custodians

Sl. No.	Particulars	As on March 31, 2012	As on March 31, 2013	As on March 31, December 2013
1	Number of FIIs	1,765	1,757	1744
2	Number of Sub-accounts	6,322	6,335	6410
3	Number of Custodians	19	19	19

Source: Annual Report, Securities Board Exchange of India

Table 2: Cumulative Net Investment by FIIs in Indian Stock Market (Amount in INR Crores)

Financial Year	Equity	Debt	Total Net Investment	Cumulative Investment
1992-93	13	0	13	-
1993-94	5,127	0	5,127	13
1994-95	4,796	0	4,796	5,140
1995-96	6,942	0	6,942	9,936
1996-97	8,546	29	8,575	16,878
1997-98	5,267	691	5,958	25,453
1998-99	-717	-867	-1,584	31,411
1999-00	9,670	453	10,122	29,827
2000-01	10,207	-273	9,933	39,949
2001-02	8,072	690	8,763	49,882
2002-03	2,527	162	2,689	58,645
2003-04	39,960	5,805	45,765	61,334
2004-05	44,123	1,759	45,881	1,07,099
2005-06	48,801	-7,334	41,467	1,52,980
2006-07	25,236	5,605	30,840	1,94,447
2007-08	53,404	12,775	66,179	2,25,287
2008-09	-47,706	1,895	-45,811	2,91,466
2009-10	110,221	32,438	1,42,658	2,45,655
2010-11	110,121	36,317	1,46,438	3,88,313
2011-12	43,738	49,988	93,726	5,34,751
2012-13	140,033	28,334	1,68,367	6,28,477
2013-14**	57513	-63591	-6,078	7,96,844
Total	**685890**	**104876**	**7,90,766**	**7,90,766**

** as on December 31,2013

Source: Securities Board Exchange of India (www.sebi.gov.in)

India has emerged important destination for global investment. Indian financial market was opened to foreign Institutional investors to widen and broaden the Indian capital market. The above table has been revealed that the cumulative net investment by FIIs as on 31, December 2013 was Rs 7,90,766 crore. Since the net investment by FIIs in India has been positive every year except 1998-99, 2008-09 and 2013-14 (Upto Dece). The net investment declined by

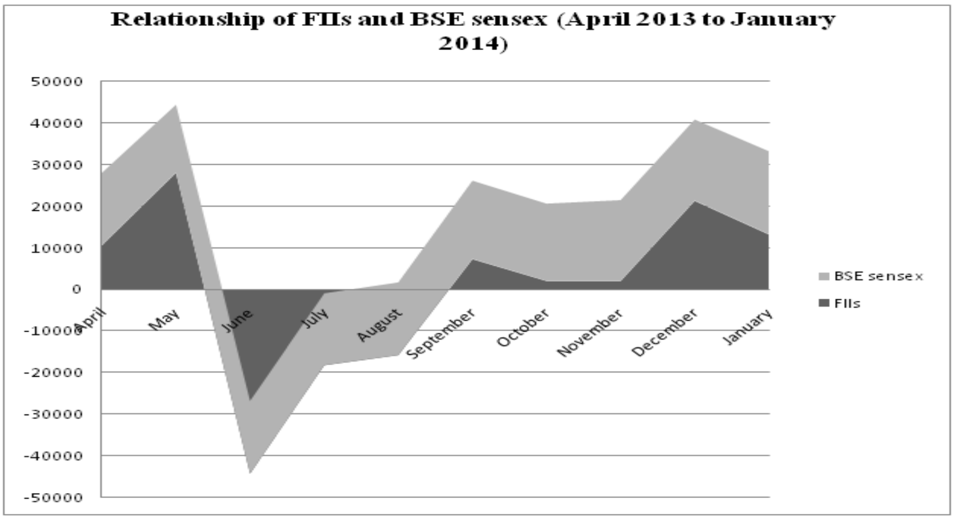
169% during 2008-09 from Rs 66179 crore to Rs -45811 crores due to large net outflow from equity segment. Several factors are responsible for increasing confidence of FIIs on the Indian stock market which include strong macro fundamentals of the economy, transport regulatory system, abolition of large term capital gain tax and encouraging corporate result. During the year 2007-08 has been shown the highest amount of portfolio investment by FIIs in the Indian market. The net investment increased by 114% from Rs 30,840 in 2006-07 crore to Rs 66,179 crore in 2007-2008 investment FIIs have withdrawn Rs. 45,811 Crore in 2009 and made less investment in the year 2011-12 which shows negative concerns among the stock market stakeholders including investors, economists, and policy makers due to financial crisis in the economy. On the contrary FIIs invested Rs.142,658 crores, Rs.146,438 crores and Rs.168,367 crores in 2009-10, 2010-11 and 2012-13respectively which shows positive concerns among the stock market stakeholders including investors, economists, and policy makers.

During the current calendar year, the net foreign institutional investor (FII) inflows into Indian equities were around Rs 75,696 crore, which is just 59 per cent of the net FII inflows in 2012. In the debt market, FIIs are the net sellers so far to the tune of Rs 44,855 crore as against net buyers to the tune of Rs 34,988 crore in CY 2012. The factors that have discouraged foreign investors may be attributed to the looming global liquidity squeeze due to the fear of Fed tapering, rise in the US government bond yields along with domestic issues like India's sluggish economy, weak Indian rupee, ballooning fiscal deficit and current account deficit. FIIs can invest in the stocks and debentures of the Indian companies. In order to invest in the primary and secondary capital markets in India, they have to venture through the portfolio investment scheme (PIS). According to RBI regulations, the ceiling for overall investment for FIIs is 24% of the paid up capital of the Indian company. The limit is 20% of the paid up capital in the case of public sector banks. However, if the board and the general body approve and pass special resolution, then the ceiling of 24% for FII investment can be raised up to sectoral cap for that particular segment. In fact, recently SEBI allowed FIIs to invest in unlisted exchanges as well, which means both BSE and NSE (the unlisted bourses) can now allot shares to FIIs also.

INSURGENCY OF FII FLOWS IN INDIAN STOCK MARKET

The main nationalised stock exchanges in India are National stock exchange (NSE) and Bombay stock exchange (BSE). National Stock Exchange which was incorporated in November 1992 as a tax-Paying company unlike other stock exchanges in the country. On its recognition as a stock exchange under the Securities Contracts (Regulation) Act, 1956 in April 1993, NSE commenced operations in the Wholesale Debt Market (WDM) segment in June 1994. The Capital Market (Equities) segment commenced operations in November 1994 and operations in Derivatives segment commenced in June 2000 with S&P CNX Nifty (Standard & Poor's CRISIL NSE Indices). The market capitalization of NSE was Rs 62, 39, 035 crores with the 1666 listed companies as on march 2013. The Stock Exchange, Mumbai popularly called Bombay Stock Exchange was established in 1875 has the greatest number of listed companies in the world, with 5211 listed as of march 2013. It is located at Dalal Street, Mumbai, India. BSE SENSEX (Sensitive index), also called the “BSE 30”. On 31 December 2007, the equity market capitalization of the companies listed on the BSE was Rs 63, 87, 887 making it the largest stock exchange in South Asia and the tenth largest in the world.

Indian stock markets are primarily driven by FIIs fund flows. Foreign institutional investors’ investment is the main driver of India stock market that depends on the movement of BSE sensex. The relationship of FIIs and BSE sensex can be understood by following chart that represents the movement of BSE sensex on Indian stock market from April 2013 to January 2014 with foreign institutional investors’ investment:



Source: Securities Board Exchange of India

Figure 1

The above chart shows that there are direct relationship between the FIIs and BSE sensex movement. Foreign investor was poured money into Indian stock market in June, July and August due to global liquidity. Besides slew of reform measures taken by the government in October 2013 also boost sentiment towards India. The BSE sensex pushup by 4.5 %, during the month of December 2013 as compared to the November 2013 that affects the investment of FIIs by 90% approx due to slew of reforms taken by government. The interconnectivity of FIIs investment and BSE sensex also explained by the Karl Pearson correlation that reveals there are highly positive association between the FIIs investment decision and BSE sensitivity indices. The table also reveals BSE sensitivity directly indices affects Foreign Institutional investors meaning that if BSE sensex indices goes up then Foreign investors invests more money in the Indian stock market, otherwise they pour money from the market.

Table 3: Result of Karl's Pearson Correlation

Month	FIIS Investment	BSE Sensex
April	10700	17319
May	28138	16218
June	-44176	17430
July	-18123	17236
August	-15696	17429
September	7376	18763
October	2128	18763
November	2133	18505
December	21376	19427
January	13323	19895
correlation coefficient (r)	0.85*	
Sig. (2- tailed)	0.029	

*Correlation is significant at the 0.05 level (2-tailed)

FII inflows are hot money that it comes and goes, creating volatility in the stock market and exchange rates. While this might be true of individual funds, cumulatively, FII inflows have only provided net inflows of capital. The p value is 0.029, significant at 5 % level of significance which indicates that there is highly positive correlation between both the foreign institutional investments and BSE sensex and the association are 85 % between them. Thus, FIIs

have become the driving force behind the movements of stock indices in the Indian stock markets. The limitation of this study is only BSE sensex has taken as the representative of stock market. FIIs have impact on Indian stock indices and other unexplained variables are also influencing the stock market Indices.

DETERMINANTS OF FII FLOWS IN INDIA

FII investments in India are influenced mainly by factors like rupee movement, policy reforms, investment regulations, interest rates, liquidity and macro economic conditions. It is the influence of the FIIs which changed the face of the Indian stock market. Screen-based trading and depository are realities today largely because of FIIs. Equity research was something unheard of in the Indian market a decade ago. It was FIIs who eased the pressure on the rupees from the balance of payments' position and lowered the cost of capital to Indian business. It is due to FIIs that a concept like corporate governance is being increasingly adopted by Indian companies; this is benefiting domestic investor also. FIIs are the trendsetters in any market. They were the first ones to identify the potential of the Indian technology stocks. When the rest of the investors invested in these scrips, they excited the scrips and booked the profits. Before the arrival of FIIs, the activity in stocks used are evenly distributed, with a little difference between the volumes in specified and cash groups. However, since FIIs concentrate on the top 200 companies against 6,000 listed companies on the BSE, in these liquid scrip's, making the less-liquid scrips totally illiquid.

There are number of factors that influence FII investments. Valuations and Earning expectations are playing important role when someone has an option of investing across countries. High inflation aggressive tightening by RBI and escalation of corruption are other factors that influenced FII investments. Corporate governance has of late become very important. India has been significant inflows in 2013 due to well regulation, transparent dealings and attractive market. But India may not see significant inflows in 2014 due to moderating inflation and float growth in emerging market and global uncertainty.

The determinants of FII flows in India are as following:

Risk: Whenever risk in home market increases, the foreign investors would start to pull out of their home country thereby creating a deficiency of funds in domestic market, hence so as to attract investment domestic interest rate would increase thereby to ensure that the above equality is restored.

Inflation: At the time of high inflation, the real return on fixed income securities like bonds and fixed deposits declines**.** Thus a bond which gives say around 7.5% interest rate actually gives a real return of just 1% if the inflation is 6.5%. If the inflation increases further, the real return would decline more.

Interest Rates: For the business, cost of borrowing rises this has a negative result on their profit margins. As a result they might even delay any investment activity which may be funded by borrowing to some later period when the interest rates are lower so as to reduce their investment costs. As it can be seen from the above table, over the past year RBI has increased the repo rate reverse repo rate, CRR and SLR. This has led to an increase in the Prime Lending Rate (PLR) and hence the general interest rate in the economy.

Political Situation: If there is some upheavals in the political situation, suppose, which decreases the asset price, the return decreases and hence FIIs would withdraw from the market. However on the other hand, if there is positive movements in the political environment, asset prices would increase; thereby increasing return and hence FII would be attracted. But the sensitivity with which investors withdraw is greater than with which they invest i.e. they would be more

cautious while investing than at the time of withdrawing. This is primarily due to their basic nature of being risk averse, thus they would react more vigorously to bad news than to good news.

Equity Returns: The results show that, the equity return in India (RBSE) is the main driving force for foreign institutional investment, which is significant at all levels. That is increase in the returns in US stock market adversely affects the portfolio investment flowing to India. Predictable risk in foreign market (SDSRF) adversely affects FII flow to India and is highly significant in the model.

GDP of India: Both have more or less direct relationship. The reason is change in capital account. When interest rates were high India was attracting lot of investments so the credit balance was high for that period. It kept on increasing form 2003-04 to 2007-08 and interest rates also kept on increasing from 2003-04 to 2007-08.besides there are various other factors like rules and regulation , taxation , govt. policies etc.

FACTORS CONTRIBUTED SIGNIFICANTLY TO THE FII FLOWS IN INDIA

Following are the factors which are contributed significantly to the FII flows to India:

Regulation and Trading Efficiencies: Indian stock markets have been well regulated by the stock exchanges, SEBI and RBI leading to high levels of efficiency in trading, settlements and transparent dealings enhancing the confidence level of FIIs in increasing allocations to India.

New Issuance: We have witnessed extremely high quality issuance during the year from companies such as NTPC, ONGC and TCS leading to strong FII participation with successful new issuance of over $ nine billion, yet another record for the year.

Attractive Markets: Indian equity markets continue to be attractive to foreign investors with expected earnings growth of over 13 per cent compared with negative growth expected among competing countries in the region such as Taiwan and Korea. Indian blue chips are seen to have high quality of balance sheets with net debt to equity of the top 30 companies being negative, with net cash on the balance sheets. However earnings growth is expected to be lower than last year and upside in stock prices will be subject to sentiments in the global markets and foreign flows to emerging markets. However high quality new issuance from PSUs and other large corporate will continue to see good demand from FIIs and domestic mutual funds have been net sellers of equities during 2004 with risk aversion still prevalent among local investors after seeing several short periods of high volatility. With the booming stock markets presently catching the headlines in local press, this trend will hopefully reverse during 2005.

Outsourcing: The rhetoric over outsourcing of jobs to India has died down after the US elections and demand will soar for Indian BPO and software services companies. However Indian software companies will need to enhance margins by going up the value chain to high level consulting and scaling up the project sizes. Significant outsourcing opportunities will also open up in textiles and drugs with dismantling of quotas for textiles and introduction of product patent regime for pharmaceuticals.

Infrastructure: Woefully inadequate infrastructure is the biggest bottleneck for the growth and profitability of Indian corporations. The administration needs to move much faster in privatization of Projects in the areas of power, transportation, ports, airports and other urban infrastructure to enhance competitiveness. This is particularly relevant due to

the fact that competing countries in Asia Pacific and China have moved at a much faster pace during the last five years and have in place a first world infrastructure.

Capital Expenditure Cycle: With strong balance sheets, high liquidity in the banking system, supportive capital markets and growing demand for goods and services we expect to see a strong wave of capital expenditure cycle during the year leading to tremendous opportunities for Indian equities.

Dollar Weakness: Analysts continue to look for a weak US dollar with the US twin deficits (budget and trade deficits) unlikely to be resolved anytime soon. Studies have shown that flows into emerging markets rise significantly during times of dollar weakness and India will continue to be a beneficiary of this trend. Indian Rupee is expected to strengthen further during 2014 which will be particularly favorable for domestic demand oriented businesses such as banks and automobiles.

Rising Commodity Prices: Demand supply dynamics in both crude and metals call for higher prices during 2012 with increasing Chinese demand and economic recovery in Japan. This has inflationary implications for India going forward, though it will be a boon for commodity counters.

Consolidation: FII activeity has been focused on large cap companies due to liquidity reasons, and hence several high quality mid cap companies trade at a valuation discount due to lack of investor demand. We expect to see significant merger activity among mid caps which will enable them to gain better valuations under the institutional radar screen, in addition to consolidation efficiencies. While China attracts significantly higher FDI, India with its highly developed capital markets will be a beneficiary of FII flows at increasing pace each year. To summaries, Indian markets have successfully absorbed the gains seen during 2012 and consolidated well during 2013 with a modest gain and look set to outperform the global financial markets during 2014.

CONCLUSIONS

In developing countries like India foreign capital helps in increasing the productivity of labor and building up foreign exchange reserves to meet the current account deficit. Foreign Investment provides a channel through which country can have access to foreign capital. Nowadays FIIs are the major contributors to the stock markets. FII investment decisions are not major factors for stock market boom and crash in India but there are numerous other reasons which determine the trend of FIIs inflows and outflows from and in India. Finally from the above we can conclude that though FII flows do have any significant impact on the Indian Stock Market but there are other factors like government policies, budgets, bullion market, inflation, economical and political condition, etc. also which put an impact on the Indian stock market. There is a positive correlation between stock indices and FIIs. In 2009 FIIs have withdrawn Rs. 45,811Crore and on the contrary FIIs invested Rs.1, 42, 658 crores in 2009-10 which reflect that strong economic conditions plays very vital role in influencing FIIs inflows in the country. One of the impacts of Global Meltdown has been observed during the year 2007-08 while in the year 2009.

FIIs have again infused money into the Indian financial market because they may predict the positive signs of growth in the Indian economy. Regulation and trading efficiencies, new issuance attractive markets, infrastructure, outsourcing, capex cycle, dollar weakness, rising commodity prices and consolidation are some factors which are significantly contributing to the causes of FII investments in India. Indian economy has undergone upsurges like running inflation rate, falling rupee, and rise in gold price. These factors have greater impact on stock market movements than FII

and basing on the movements in the stock markets, FIIs strategically diversify. Many eminent authors are optimistic about the economic outcome in the next one year in several sectors that look attractive for a variety of reasons. NBFCs look attractive along with private banks because of the upcoming growth opportunities, while defensive sectors like Pharma and FMCG continue to be appealing because of their all-seasons flavor.

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